Telephony

AN INTERTEC PUBLICATION DECEMBER 16,1991 FOR TODAY'S COMPETITIVE PUBLIC NETWORK MARKET $3

Annual Domestic Review & Forecast Issue

An uncertain future for the LECs

Rating the RHCs

N.J. BELL, CATV FIRM SPAR

GTE's JOHNSON TO RETIRE

MONDAY, DECEMBER 16, 1991 Volume 221, No. 25

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FOR TODAY'S COMPETITIVE PUBLIC NETWORK MARKET

All across the country, 1991's recession and regulatory and technological barriers resulted in sagging capital expenditures by many local exchange carriers. And industry watchers don't expect an upturn until 1993. Cover computer illustration by Holly Seguine

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TELEPHONY (ISSN 0040-2656) is published weekly (except for a combined issue the last week of December) for $45.00 one year, $70.00 two years. Outside U.S. $80.00 one year. Air mail for $185.00 for U.S., $225.00 for Canada. Air Express one year outside U.S. and Canada for $150.00. Single copies $3.00 each (payable in advance); outside U.S. add $1.00. Subscription rates apply to employees of operating telephone companies, telephone consultants, contractors, interconnect companies, specialized common carriers, military, government associations, private communications users, schools, libraries. Published by Intertec Publishing Corp., 9221 Quivira Rd., Overland Park, KS 66215. Second-class postage paid at Chicago, IL and additional mailing offices. POSTMASTER: Send address changes to TELEPHONY, P.O. Box 12960, Overland Park, KS 66282-2960. Copyright 1991 by *Telephony* Division, Intertec Publishing Corp. All rights reserved. Permission to photocopy for internal or personal use or the internal or personal use of specific clients is granted by *Telephony* for libraries and other users registered with the Copyright Clearance Center, provided that the fee of $1.00 per page is paid directly to CCC, 21 Congress St., Salem, MA 01970. Special requests should be addressed to the publisher.

Domestic review and forecast

An uncertain future for LECs

CAROL WILSON, Editor

The numbers don't lie, and for the second straight year, they indicate little or no growth in capital spending by U.S. local exchange carriers.

The 1991 *Telephony* review and forecast shows spending during the past year fell almost 2% among the Bell regional holding companies, while spending among top Independents fell 3%. The same research shows only a slightly brighter picture for 1992, when RHC spending is expected to grow 3.5% and Independents are expected to contract another 4% (see chart on page 18).

This is one picture, though, that is impossible to paint by the numbers alone.

Industry analysts agree that key factors—including the recession, and regulatory and technological uncertainties—have combined to hold back LEC spending on equipment, capitalized labor, wire and cable, vehicles, computers and other capital items. There is also general agreement that no movement in any one area, such as a lifting of federal restrictions

on telephone company ownership of cable TV companies, for example, will trigger major spending increases in the coming year.

The analysts see definite signs, however, of renewed spending beginning in 1993 and of major spending growth in the middle decade years, as LECs move to deploy new technology and tap new markets.

"The LECs are battening down the hatches for an extended period of lackluster performance," says Peter Bernstein, analyst with Probe Research, Cedar Knolls, N.J. "I can't fault them for being conservative, given current economic conditions. This may be the most difficult year to access the meaning of their construction budgets."

"The RHCs must have a more comfortable environment in which to spend," says Steve Sazegari, telecommunications analyst with Dataquest, San Jose, Calif. "Right now there are many uncertainties in the regulatory arena, in the standards arena and in the technology arena. For the RHCs to overcome this will take time. Setting aside the economy for a moment, I think we see some movement toward more expenditures in the 1994-95 time frame, especially with standards and regulatory problems clearing up."

Feeling the Pinch

The most obvious cause of the current conservatism among the LECs is the state of the nation's economy, which is driving down growth in access lines and demand for new business services. According to the U.S. Telephone Association, the number of access lines grew less than 3% in 1990.

"Traffic growth is slowing, so, as any company would do, the LECs are pulling in a little bit," says Paris Burstyn, analyst with Business Research Group, Newton, Mass. "The new technologies aren't deployed as rapidly, but at the same time the demand doesn't grow as rapidly for high-bandwidth services. The customer side is also growing more slowly."

Because planning is done two years out, LEC spending budgets actually have been somewhat insu-

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Local Exchange Carriers' Network Expansion Budgets ($000,000)

	1989	1990	1991	1992
7 Regionals				
Ameritech	1,862.1	1,927.0	1,930.0	2,088.0
Bell Atlantic	2,461.3	2,352.0	2,331.0	[a]2,447.6
BellSouth	3,015.5	2,888.8	2,727.0	2,794.6
Nynex	2,095.0	2,300.0	2,300.0	2,300.0
Pacific Telesis	1,491.0	1,760.0	1,690.0	[b]1,830.0
Southwestern Bell	1,290.0	1,506.0	1,501.0	1,433.0
U S West	1,800.0	2,000.0	2,000.0	2,100.0
Top Independents				
GTE[c]	2,798.0	2,955.0	2,864.0	2,602.0
United Telecom	660.0	653.0	621.0	637.0
SNET	356.7	345.0	300.0	300.0
Centel	187.3	225.7	[d]170.0	[d]200.0
Alltel	184.0	203.0	210.0	230.0
Puerto Rico Telephone	186.0	199.6	205.5	210.0
Cincinnati Bell	142.2	126.5	117.0	113.0
Rochester Telephone	66.2	61.0	55.7	52.7
C-TEC	36.1	40.9	44.6	34.7
TDS	54.6	66.0	65.0	69.0
Lincoln Telecommunications	29.9	30.8	34.1	34.0
Anchorage Telephone	8.8	12.9	16.7	21.2
Century	54.0	59.0	110.0	111.0
Consolidated Network	NA	NA	11.0	12.0
LEC Composite				
Regionals	14,014.9	14,733.8	14,479.0	14,993.2
Independents	4,763.8	4,978.4	4,824.6	4,626.6
Total	18,778.7	19,712.2	19,303.6	19,619.8

[a]Bell Atlantic 1992 figure projected at 5% growth
[b]Pacific Telesis 1991 and 1992 figures do not include Nevada Bell
[c]GTE figures include Contel due to merger
[d]Centel 1991 and 1992 figures do not include Central Telephone Cos. of Iowa and Minnesota

lated from recessionary effects, says Fritz Ringling, analyst with Insight Research Corp., New York.

"There is a lag between the economy and their investments," he says. "Companies commit to making certain investments. I suspect what will happen in 1992 is that they will pare down their budgets from their overspending in 1990 and 1991. I would expect 1992-93 [spending] to be flat to down."

There also is pressure from Wall Street for LECs to trim costs, as many have done so by cutting people and keeping equipment budgets tight. Between 1990 and 1991, the local telephone industry cut more than 20,000 jobs, or 3% of its personnel total.

"The RHCs in particular worry a lot about their stock prices," says Bernstein. "There are a couple of ways of making your bottom line look good in a downturn, and one is not to spend money."

There is concern, however, that early retirement programs and other job cuts are "eliminating too many experienced craftspeople," says Bernstein. "One of the things being said about AT&T in the wake of its outage problems is that it may have gotten rid of too many experienced people."

Where to Invest

Despite the gloomy economic news, analysts agree that large LECs, particularly the RHCs, are still relatively well-heeled. But the combination of slow access-line growth and regulatory restrictions on earnings creates a disincentive for the RHCs to invest their money in upgrading their local telephone networks. Increasingly, they are looking overseas, where they can earn a higher return on investment.

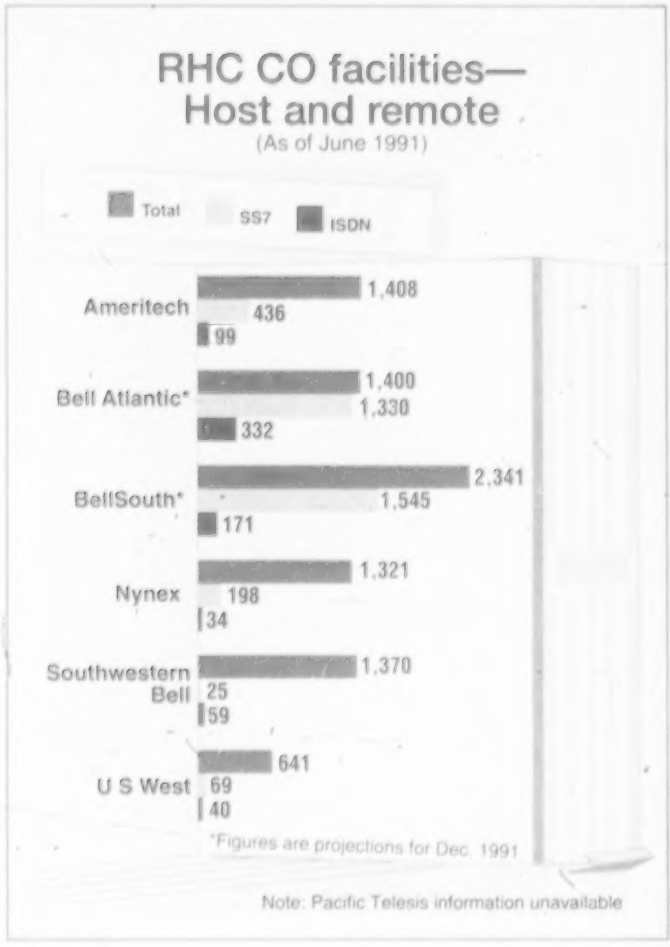
"The telcos have realized that there are limitations to what they can earn in their own operating territories and have put much more money into ventures that don't have an impact here in the U.S., like foreign cable and cellular systems," says Ringling. "They have invested progressively in new privatization, and that will be a continuing trend in 1992."

Such investments represent higher risks, but also much greater rewards, he adds. "Telcos are expecting a higher return from those investments than the 11% to 12% they can earn on their local network operations in the U.S."

Although the RHCs insist that their investments overseas do not drain cash from U.S. network modernization plans, there is, in fact, one pool of investment money, says Sazegari. "Their investments overseas do create a scenario for cash drain," he says.

The LECs have had considerable success in recent years in lobbying state regulators for incentive rate plans that, at minimum, allow them to keep part of the profits earned beyond the traditional rate-of-return limits. Incentive regulatory plans are in place in many states, either on a trial or limited-run basis, and theoretically pave the way for LECs to realize a greater return on their investment dollar.

"The success of these plans has been less than the market anticipated, however," says James Stork, analyst with Duff and Phelps, Chicago. Often this is because LECs have had to "buy into" such plans by offering rate cuts up-front, and those costs and the depressed economy have held down profit growth, he adds.



"Hopefully, companies will start earning at the incentive level. But if it's a three-year or four-year plan, the question is when will they earn at the level where they share excess profits with ratepayers?" asks Stork. "And if they are able to push returns up in the final year of an incentive rate plan, then will regulators say, 'OK, now let's cut your rates another 10% and start over?' It isn't clear yet whether these plans provide long-term incentives for telco investment. There are still too many unknowns."

It is no exaggeration to say that the entire local exchange picture could be characterized as a great unknown. Tremendous technological change beckons in the form of intelligent broadband networks, offering ubiquitous high-speed voice, data and image transmission, a host of new revenue-producing services, including personalized communications services, that will revolutionize communications.

But it is not at all clear how LECs will evolve their networks, since standards for these technologies, which include the synchronous optical network, asynchronous transfer mode switching, the Advanced Intelligent Network and new operations support systems (OSSs), are not complete. The OSS standards, in particular, lag behind since they must be adapted with each new technological advance.

Because choices made today will have an impact well into the future, the LECs are cautious in their

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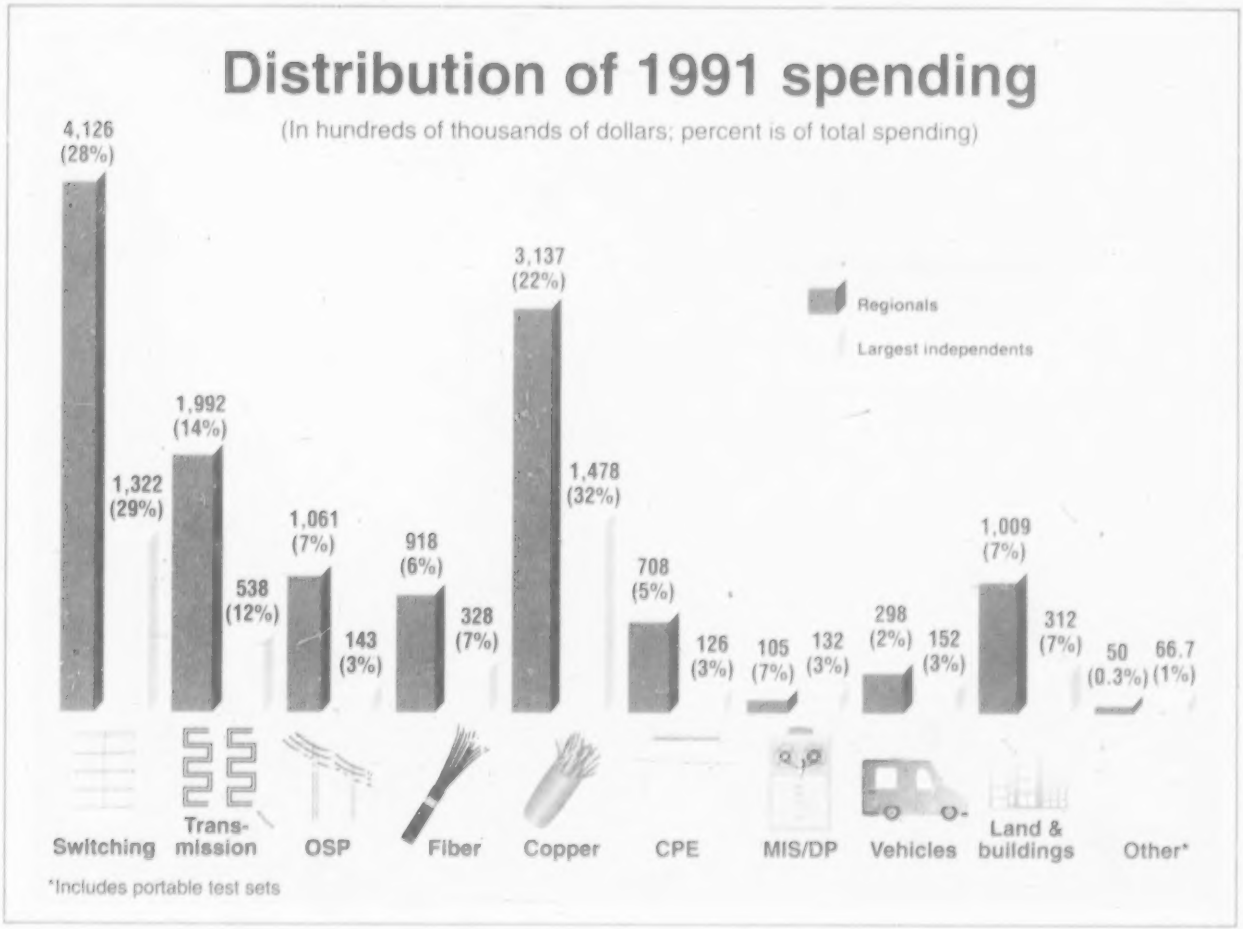

Review and Forecast *continued*

approach. For example, there is general agreement that SONET is the future of public network transmission. Until SONET standards are finalized, however, OSSs have been equipped to handle SONET messages. Because it is still unclear how SONET will coexist with asynchronous equipment in the transition phase, many LEC's are being conservative with their equipment deployment.

"New technologies are not having the impact that they should because the standards have not been put into place," says Ringling. "It is going to take another five years or longer before everyone agrees on everything. Telcos are holding back—they'll deploy new systems selectively where major customers want it—but they are nervous and rightly so. They could be stuck with equipment that is obsolete."

"The LEC's are facing critical choices about their broadband platform," adds Sazegari. "They must buy a platform they can expand into the future with a minimum level of investment. Although certain vendors have certain solutions, they are offering different options, and the RHC's must look at those options.

"What we are in now is an elongated trial period," Sazegari continues. "We see two different internal forces within the telco that are at odds. One is network planning, which wants to put some of the new stuff in place right away—they are more aggressive and excited. The other is operations, and the operational people want to see a solid OSS solution. Although Bellcore has done a lot of work in this area, the level of standardization has not been solidified for the OSS. So new technologies, even if they are acquired, often operate in isolation."

Local loop competition is the one great unknown that could have an immediate, major impact on LEC spending, the analysts agree.

The RHC's are moving to offer new data communications services, particularly for local area network interconnection, but here there are also technological uncertainties and market questions. Large corporate users are feeling the recessionary pinch and also are uncertain about new technologies, says George Newman, analyst with IDC, Framingham, Mass.

"This seems to be a period of market adjustment

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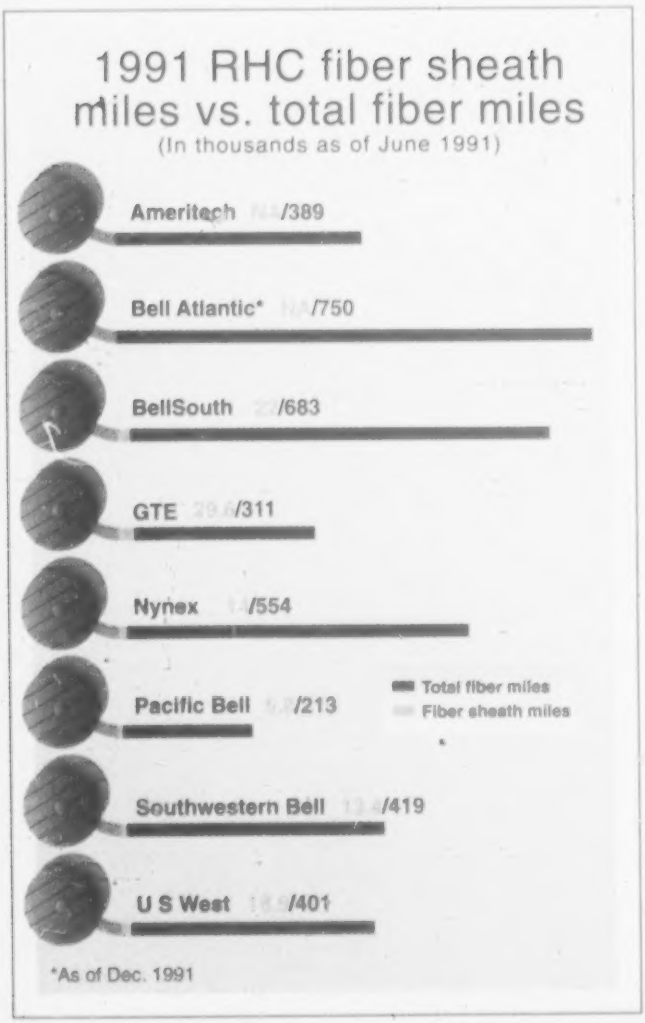
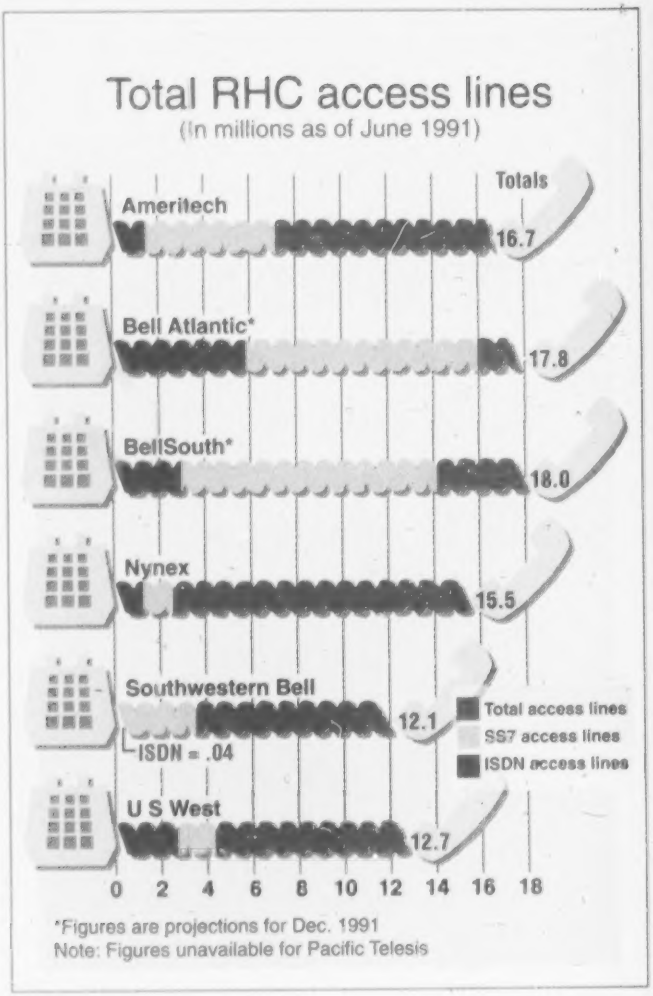
midstream," says Newman. LECs are figuring out what kinds of data services they can offer, whether it's frame relay or switched multimegabit data service, and how they can bundle the services, he says.

"They know they need to build the infrastructure of the future," Newman says, "but we're not there yet. There are a lot of internal management decisions to be made as to the future direction. They want to play in this potentially explosive market, but that could entail a sizable investment. I suspect some will be more aggressive than others."

LECs are looking to the market for direction, Newman says, but are finding users with confusion of their own. "Companies are retracting a bit and examining what is most fruitful—a private solution or the public carriers," he says. "Everyone is kind of stymied and looking at each other for direction."

In addition, the LECs—particularly the RHCs—are not at all certain what role they will be allowed to play in offering services such as video entertainment to the home that could provide the financial incentive for major technology deployment. Such decisions lie in the hands of a politically fickle Congress, which would have to reverse the 1984 Cable Act prohibiting cable/telco cross-ownership, and the Federal Communications Commission, which will determine spectrum allocation for personal communication services that could determine competitive boundaries. Congress also may act on lifting all or some of the Modified Final Judgment restrictions on the RHCs, which would allow them into long-distance service and manufacturing. Or it may put new restrictions on the RHCs' newly granted ability to provide information services content.





On the state level, there is ongoing uncertainty as to the extent that LECs will continue to gain pricing freedoms and improve depreciation schedules that will allow them to write off old equipment more rapidly. There is also the major issue of competition and how it will be structured.

The Wild Card

Local loop competition is the one great unknown that could have an immediate, major impact on LEC spending, the analysts agree. Such competition, in the form of competitive access providers (CAPs), could force LECs to move quickly to modernize their networks, at least where they are under competitive pressure. The two largest alternative carriers, Metropolitan Fiber Systems and Teleport, are deploying fiber rings in major urban areas and, in

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some instances, offering new technologies more rapidly than LECs. Teleport is operating a SONET-based network in Chicago, for example, while MFS is offering high-capacity broadband services in Houston.

CAPs also are pushing for interconnection to the public network, and there are indications that regulators in some areas are prepared to open the door to full competition, following the lead of Illinois Commerce Commission Chairman Terrence Barnich *(Telephony, Dec. 2, page 8)*.

"The LECs are concerned about competition, but that concern isn't reflected in their capital budgets," says Ringling. "If, for example, competition had a major impact on Illinois Bell revenues, they would rethink their investment strategy and pour substantial investment into the urban and suburban systems, especially into transmission and fiber systems. There could be a quick turnaround, if the LECs felt they needed to do that."

There is some danger, however, if the LECs wait too long to respond to competitors, particularly in markets such as data communications, where demand is building rapidly.

"The real question is what is the time frame for them to respond to competition?" comments Bernstein. "Is it now, is it next year, or is it when they get competition taking 15% of their business? This cuts to the heart of their mind-set and their culture—how fast can they turn the ship?"

"If [the LECs] want to be perceived as nimble providers of modern data communications services, they have to be ready to move and to prove they are a little more flexible," adds Newman. "They really need to reinvent themselves for users."

The Bright Side

For all of the uncertainty, however, the U.S. telecommunications market remains healthier than what concerns over the LECs' future spending might lead one to conclude. Even with little growth this year, the market totals—$19.3 billion—are impressive. And closer examination shows comparisons with past spending are more favorable than hard numbers indicate.

"It's still a huge market," says Burstyn. "People lose sight of the fact that 40% of the world's market is here. Regular maintenance and upkeep alone provide a solid base of investment for manufacturers."

In addition, says Salomon Brothers' Michel Guite, today's investment dollars buy more equipment and less capitalized labor than in the past.

"Because telephone companies commingle equipment spending with labor costs for installation and maintenance, capital budgets may be down as equipment buying increases," he says. "In addition, a much higher percentage of investment today is in software, and the LECs often consider software as an expense item, not a capital budget item."

As a result, says Stork, increased software expenses show up in the "right to use" fees reported in quarterly earnings, not in capital budgets.

There is ample evidence that LECs are getting more bang for their equipment buck as a combination of technology improvements and competitive pressure drives down the cost of most equipment.

"Telecommunications equipment manufacturers are participating in an extraordinarily powerful market that has momentum, breadth and depth," says Guite. That is why the telecom equipment sector has outperformed home markets on a global basis and Standard & Poor's 500 in the U.S., he maintains.

While other analysts don't completely share Guite's optimism, they generally agree that LEC spending will take a definite upturn toward the middle of the decade, beginning either in 1993 or 1994, depending on whether telcos are allowed into markets such as CATV and whether competition becomes a real threat in major markets.

The real challenge for the LECs is to avoid being paralyzed by the current market uncertainty, so that strategic planning doesn't become merely reactive. Instead, they should position themselves to capitalize on technological and political change, while protecting their current bottom line.

"What the LECs need is an articulation of a vision of where they want their networks to be five years from now, 10 years from now and so forth, and what the service agenda is that will go over their lines," says Bernstein. "Based on that, they can make judgments relative to their construction budgets and determine whether they are spending enough. Without a vision of where they want to go and how they want to get there, it is impossible to analyze what they are doing today." ■

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